SUPREME COURT, U.S.

MOTION FILED

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IN THE

Supreme Court of the United States

October Term, 1955

No. 373

COMMISSIONER OF INTERNAL REVENUE,
Petitioner,

v.

PHILIP J. LOBUE,
Respondent.

MOTION FOR LEAVE TO FILE BRIEF AMICUS CURIAE AND BRIEF FOR THE AMICUS CURIAE

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MOTION FOR LEAVE TO FILE BRIEF AMICUS CURIAE

Comes now RAYMOND G. LOCHIEL, by his undersigned counsel, and respectfully moves this Court for leave to file the attached brief amicus curiae and in support thereof shows as follows:

1. Amicus is petitioner in Docket No. 44273 now pending in the United States Tax Court. That case involves the question of the taxability to him of income arising out of his exercise of stock options granted to him by his corporate employer, that question being controlled by Section 39.22(a)-1(c) of Treasury Regulations 118, as amplified by Treasury Decision 5507 and Income Tax Ruling 3795.

2. Amicus is one of twelve employees of Capital Airlines, Inc. who received options to purchase stock in that corporation pursuant to the same corporate resolution. Amicus' case now pending in the United States Tax Court and the federal income tax returns of several of the other optionees are being held in abeyance by specific arrange-

ment with representatives of the Internal Revenue Service, pending disposition of this case.

3. Counsel are familiar with the legal question involved in this case by virtue of the fact that, with the consent of counsel for both petitioner and respondent here, counsel filed a brief amicus curiae in this case when it was before the United States Court of Appeals for the Third Circuit. With the permission of that Court, counsel likewise participated in oral argument before that Court.

4. Based upon discussions with representatives of the Internal Revenue Service, counsel believes that if this Court should find in this case that the United States Court of Appeals for the Third Circuit was correct in finding that the applicable regulations, cited above, are invalid, amicus' case and those of the other optionees of Capital Airlines, Inc. might be disposed of by administrative settlement without further judicial proceedings.

5. Although there is no difference in principle between the positions of amicus and of respondent here, amicus has not seen respondent's brief and therefore does not know the exact nature of the arguments to be made by respondent in this Court or the extent to which respondent's arguments on the merits might be influenced by the particular facts in this case. Since both petitioner and respondent here are inevitably concerned with the precise facts in this case, counsel suggests that it would be helpful to this Court to have before it a separate brief dealing only with the fundamental legal question of the validity of the applicable regulations and that the proposed brief amicus might well make certain points not apt to be made in respondent's brief.

6. As indicated by the consent herewith filed, counsel for the respondent has consented to the granting of this motion. Counsel for the petitioner has seen fit to with-

hold his consent, citing as one reason, the fact that there might be others interested in filing briefs amici curiae and that if consent were granted there would be no basis for withholding consent from such others. To our knowledge the granting of respondent's consent in the Court of Appeals for the Third Circuit, and the filing of our brief amicus there did not produce any additional requests from other possible amici in that court, of up to this date, in this Court. It is respectfully suggested therefore that there is no adequate grounds for this reason.

WHEREFORE, it is respectfully requested that this Court grant this motion.

Respectfully submitted,

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December 5, 1955

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Re: No. 373 Commissioner of Internal Revenue, Petitioner v. Philip J. LoBue

Dear Mr. Redman:

This is to advise you that you have my consent to file a brief amicus curiae in the above-entitled proceedings now before the Supreme Court of the United States.

Sincerely yours,

/s/ Richard F. Barrett
Counsel for Respondent

RFB:d
AIR MAIL

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No. 373

COMMISSIONER OF INTERNAL REVENUE,
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Respondent.

BRIEF FOR THE AMICUS CURIAE

QUESTION PRESENTED

Does Section 22(a) of the Internal Revenue Code of 1939 warrant a conclusive presumption that, regardless of all other facts, an employee realizes ordinary income, to the extent of the difference between the option and market prices on the date of exercise, when he exercises an option awarded to him by his corporate employer to purchase stock in the corporation?

SUMMARY OF ARGUMENT

Both the Tax Court and the Court of Appeals for the Third Circuit held in this case that Section 39.22(a)-1(c) of Treasury Regulations 118 is invalid in its conclusive

presumption that without regard for anything else, the exercise of every employee stock option provides additional compensation to the extent of the difference between the option and market prices on the date of exercise. Both courts held also that a finding of additional compensation in the exercise of such an option depends upon all the facts in each case, upon analysis of all relevant factors as they have been developed by the courts without break for 22 years. Amicus urges that these conclusions are correct, that they are supported and required, not only by judicial decision, but also by the history and development of congressional action in the area.

ARGUMENT

Prior to the Revenue Act of 1950, there had been no specific statutory treatment of stock options as such. The governing section was 22(a) which simply provided for the taxation as gross income of all kinds and forms of compensation for services. It is fundamental—and this is where the Commissioner's argument falls before it even gets started—that Section 22(a) does not tell us what constitutes compensation in the first instance. It does not determine whether or not a particular item is compensation. Despite its admittedly broad scope, it does not operate except on something that is income initially. It says simply that if something is compensation, it is to be taxed as such despite the fact that it is in the form of a stock option. Perhaps, save for possible constitutional questions, the statute could have provided that every stock option is compensation taxable as such. But it does not. The current regulations do—and in a manner in which a whole host of cases has said has the effect of creating income where there is none in the first instance. Regardless of the wide purview of Section 22(2), administrative fiat cannot do that.

The Original Regulations and Concurrent Decisions

The first effort to cover stock options (even though not by name) was the administrative amendment in 1923 to the Treasury Department's income tax regulations. Treasury Decision 3435, II-1 Int. Rev. Cum. Bull. 50. Then, as now, the rule was stated in terms of bargain sales of property:

> "Where property is sold . . . by an employer to an employee, for an amount substantially less than its fair market value, . . . such employee *shall* include in gross income the difference between the amount paid for the property and the amount of its fair market value." (italics added)

Despite the existence of this mandatory provision, the courts looked to the particular facts of each case to determine whether or not the grant or exercise of a stock option involved ordinary income to the optionee. They either specifically rejected the regulation,[1] or ignored it[2]—although it would seem clear that to ignore a regulation which by its terms is both applicable and mandatory, is necessarily to reject it. These decisions established the rule that the tax nature of a stock option depended upon the intent of the parties, as determined by all the facts; and that when an examination of all the facts determined that the option was given as compensation, then—and only then—the employee realized ordinary income when he exercised the option, to the extent of the "spread".

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[1] See, e.g., *Charles E. Adams*, 39 BTA 387 (1939); *Herbert H. Springford*, 41 BTA 1001 (1940); *Commissioner* v. *Van Vorst*, 59 F.2d 677 (9th Cir. 1932); *Taplin* v. *Commissioner*, 41 F.2d 454 (6th Cir. 1930); *Hawke* v. *Commissioner*, 109 F.2d 946 (9th Cir. 1940); *Rossheim* v. *Commissioner*, 92 F.2d 247 (3d Cir. 1937).

[2] See, e.g., *Delbert B. Geeseman*, 38 BTA 258 (1938); *Gordon M. Evans*, 38 BTA 1406 (1938).

The 1939 Regulations

In 1939, after the decision in *Geeseman*, 38 BTA 258 (1938), the Internal Revenue Service finally acquiesced. It amended the language quoted above by adding the provision that the spread would be taxable as income "to the extent that such difference is in the nature of . . . compensation for services rendered or to be rendered", Treasury Decision 4879, 1939-1 (Part 1) Int. Rev. Cum. Bull. 159. Between 1939 and the decision by this Court in *Commissioner* v. *Smith*, 324 U.S. 177 (1945) this rule prevailed, as a matter of both judicial and administrative construction.

The Smith Case

In the *Smith* case, taxpayer *admitted*, both in his Tax Court petition and on the witness stand, that the option had been awarded to him as compensation for services rendered; he argued nonetheless that there was no tax until he sold the stock. But the Tax Court found that he realized compensation to the extent of the spread between option and market prices at the time of exercise. The Court of Appeals reversed; it adopted the taxpayer's argument and contrary to a whole host of decisions, held that despite the fact that the option was admittedly compensatory and taxable as such, there was no income realized until the stock was sold. This Court granted certiorari because of a conflict with *Connolly's Estate* v. *Commissioner*, 135 F. 2d 64 (6th Cir. 1943) which was illustrative of the many decisions holding that where the option is compensatory, its exercise produces ordinary income.

The *Smith* case thus never posed the question of whether or not the option involved compensation; *that was conceded at the outset.* The only question in *Smith* was the amount and time of the compensation involved.

(See for example the opinion below, 223 F. 2d at 369). It was on this basis that the Commissioner presented the case to this Court, which held that the Tax Court's finding was supported by the evidence and was proper both under the broad scope of Section 22(a) and the then regulations.

The *Smith* case then is this Court's confirmation of the many decisions holding that only where an option involves compensation in the first instance does it constitute ordinary income, and under the facts of that case, the amount of income was measured by the spread between the option and market prices at the time of exercise.

> "It will be seen that the Smith case does not hold that the exercise of any stock option given to an employee may result in taxable gain to him when exercised even though the option was given to enable him to acquire a proprietary interest in the corporation and not as compensation." (*Commissioner* v. *LoBue*, 223 F.2d at 369)

Thus, the *Smith* case did not change pre-existing law; to the contrary, and in response to the Commissioner's specific contention,[3] it reaffirmed the principle that *only if* compensation is involved, Section 22(a) is broad enough to permit measuring the amount of the income by the option-market price spread at time of exercise. *Commissioner* v. *Straus*, 208 F.2d 325 (7th Cir. 1953); *Donald B. Bradner*, 11 TCM 566 (1952), affd. without opinion, 209 F.2d 956 (6th Cir. 1953); *James C. Hazelton*, 12 TCM 398 (1953). In *Straus* the court rejected the Commissioner's specific argument that *Commissioner* v. *Smith* "authoritatively settles" anything and instead adopted the following analysis of the Tax Court (11 TCM 786, 789):

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[3] Commissioner's brief in *Smith*, pp. 11, 14, 22 and 25.

"Whether income is realized by an officer or employee upon the exercise of an option granted him by his employer for the purchase of its stock at a fixed price is to be determined from the intent and purpose of the employer in the granting of the option. This intent must be determined from all the facts and circumstances surrounding the transaction. If the option be granted as consideration for services rendered, the gain resulting from its exercise represents income subject to tax *Commissioner* v. *Smith*. . . . If the option be granted by the employer not to compensate the officer or employee for services rendered or to be rendered, but to enable him to acquire a proprietary interest in the corporation employing him, the transaction does not result in a realization of income upon the exercise of the option."

The Current Regulations

Despite his own argument in *Smith* that each case depended upon its own facts, the Commissioner apparently interpreted the decision in a totally different light. After that decision he restored to the regulations their original, pre-1939 mandatory presumption of ordinary income. Income Tax Ruling 3795, 1946-1 Int. Rev. Cum. Bull. 15 and Treasury Decision 5507 (Id. at 18). They now provide that the option-market spread "*is* in the nature of compensation and *shall be* included in the gross income of the employee" (italics added). The Commissioner makes no particular point as to the authority for the regulations; presumably he relies upon Section 22(a) itself.[4] If this is so, then nothing had happened—in the

[4] This failure to take any position completes the cycle of the Commissioner's vacillation on the point, a matter of some importance in evaluating the argument that the regulations have long provided anything. As Judge Maris pointed out in his opinion below, the Commissioner had been contending that the current version of the regulations was based on the *Smith* case but he abandoned

law or the cases—to warrant the change (except obviously a change of administrative heart). The conclusive presumption of income restored to the regulations was thus necessarily in conflict with a line of cases unbroken for over 20 years.[5] The regulations were an improper extention of the statute the first time and were treated as such by all the courts.[6] They necessarily suffer from the same fatal defect this time. There is no basis for testing the nature of a stock option by any but the same standards that have been applied uniformly by the courts down through the years.

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that position for the first time in his brief in the Court of Appeals (223 F.2d. at 369). The Tax Court (22 TC at 444) and the Senate Finance Committee considering the enactment of what became Section 130A (1950-2 Cum. Bull. 483, at 526) and the House Ways and Means Committee considering HR 6712 (Report No. 2087, 80th Cong. 2d Sess., p. 4; see *infra*, p. 19) all understood that the regulations were founded on *Smith*. So did every other court which had occasion to comment on the *Smith* decision (see cases cited on pp. 5 and 13) and so did every one of the numerous commentators on the subject. For a partial list see 31 Taxes 735, 737 (Sept. 1953). The reasons for this almost universal misunderstanding are fairly obvious. First the Commissioner fostered the impression by his numerous references to *Smith* in his argument in many cases. Second, there was no other visible "development" in the area which could have prompted the radical change in administrative position.

[5] The original 1923-1939 regulations required that there be a "substantial" spread between option and market prices before the mandatory presumption became operative. Despite that qualification, those regulations were rejected by the courts. The same treatment follows *a fortiori* for the current regulations which are without qualification.

[6] As this Court has said: "Treasury Regulations can add nothing to income as defined by Congress." *M. E. Blatt Co.* v. *U. S.*, 305 U.S. 267, 279 (1938). See also *Campbell* v. *Galeno Chemical Co.*, 281 U.S. 599 (1930).

Proprietary v. Compensatory Options

But the Commissioner maintains that these standards are meaningless; that every one of those cases[7] is wrong—and in effect, each one is wrong in principle, regardless of result, since each one was decided on the basis of its particular facts, whereas according to the Commissioner, no inquiry into the facts is permissible. For the same reason, the Commissioner urges also that his own regulations in existence between 1939 and 1945 were likewise erroneous. In other words the Commissioner is simply making the same argument[8] he advanced in every case involving the years 1923 to 1939 when the original regulations, with the same mandatory presumption of compensation, were in effect—the same argument which was rejected—either specifically or by necessary implication—in every one of those cases. It is the same argument made on the basis of the same statutory provision, with no indication of any kind that in the meantime the meaning of that provision (certainly not its terms) had changed.

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[7] The choice between compensatory v. proprietary options has been made on the basis of an analysis of all the facts on at least one occasion in nine of the eleven Courts of Appeals (the First and Fourth Circuits have apparently never ruled on the question) and in a whole host of Tax Court and District Court decisions. Illustrative of the appellate court decisions are *Choate* v. *Commissioner*, 129 F.2d 684 (2d Cir. 1942); *Rossheim* v. *Commissioner*, supra; *Alger-Sullivan Lumber Co.* v. *Commissioner*, 57 F.2d 3 (5th Cir. 1932); *Bradner* v. *Commissioner*, supra; *McNamara* v. *Commissioner*, 210 F.2d 505 (7th Cir. 1954); *Omaha National Bank* v. *Commissioner*, 75 F.2d 434 (8th Cir. 1935); *Van Dusen* v. *Commissioner*, 166 F. 2d 647 (9th Cir. 1948); *Bothwell* v. *Commissioner*, 77 F.2d 35 (10th Cir. 1935); *Merhengood Corporation* v. *Helvering*, 89 F.2d 972 (D.C. Cir. 1937).

[8] Except in those cases, as when the employer's right to deduction was in issue, where the government argued there was no compensation at all; i.e. precisely contrary to the result it urges here. e.g. *Gardner-Denver Co.* v. *Commissioner*, 75 F.2d 38 (7th Cir. 1935).

These arguments of the Commissioner lead the way to the basic question: are all of the cases wrong? Are they all wrong in looking to all of the facts in each case to determine the tax result of a stock option? Is the Court below wrong in this unequivocal statement (223 F.2d at 369):

> "But we cannot agree that section 22(a) supports the amendment in compelling any economic benefit derived by a corporation's employee from the exercise of a stock option to be treated as compensation and taxable as such regardless of whether or not it was so intended."

The Commissioner, of course, says yes, all this is wrong. He argues that since the option is given to an employee it must be either a gift or compensation; there is no middle ground. Since there is no allegation of gift in these cases the option must therefore be compensatory. The Commissioner goes on to say—as he must—that every court, as well as the government during the years 1939 to 1945, was misled by the erroneous assumption that the corporation's desire to give the optionee the opportunity to acquire a proprietary interest in the corporation necessarily meant that the option was not compensatory. In our view the Commissioner is the one confused or misled. It is not denied that the employee's status as such is relevant; of course, the initial award of the option has something to do with the optionee's employment. But it does not follow that such an option automatically qualifies as compensation taxable as such.

An oft-quoted analysis of this fundamental aspect of the problem appears in *Geeseman*,* (38 BTA at 263):

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* This was the decision in which the Commissioner acquiesced (1937-1 Int. Rev. Cum. Bull. 13) and which prompted the 1939 change which removed the mandatory provision from the regulations.

"To hold that a transaction of the character here involved is a 'bargain' purchase having nothing to do with the employer-employee relationship, or, to the contrary, that it is not a purchase but constitutes the receipt of compensation having nothing to do with the purchase of property, to the extent that the fair market value exceeds the purchase price, is to ignore obvious facts and to assume a case substantially different from the one before us. In the first place, it may not be said that the acquisition of the stock of Continental Can Co. was not a purchase merely because the price paid was substantially lower than the price at which the same stock was then selling on the market, and, in the second place, obvious facts are ignored if it be said that the stock transaction was separate and apart from, or was not based upon, the employer-employee relationship, or that it had no relation to services rendered or to be rendered. In practically all such cases both elements are present and decision is impossible if the absence of one or the other is essential thereto.

"Normally the purchase of property does not result in the realization of taxable gain, but rather in the acquisition of an asset with a view to the later realization of gain or profit through its use or subsequent sale, and upon sale the general rule is that no taxable gain is realized until the seller has recovered his cost or capital . . . Accordingly it is our opinion that as a prerequisite to the conclusion sought by the respondent it should definitely and clearly appear that a transaction, which in form is nothing more than a purchase and to an obvious and substantial extent is unquestionably a purchase, is in fact to some extent the payment of compensation for services rendered or to be rendered."

Perhaps an equally good analysis appears in the Commissioner's own argument to this Court in the *Smith* case. After noting the presumption of compensation that stems from the employer-employee relationship, the Commissioner argued (pp. 11-12 of his brief in the *Smith* case):

> "This may not always be true so far as bargain purchases are concerned. Conceivably such a bargain may occur where an employer can find no other buyer in a stagnant market, or even where the sole purpose is to insure the employee's unflagging loyalty by giving him a stake in the employer's business. [Citing the *Geeseman* and *Adams* cases, *supra*.] If as a matter of fact, however, a transaction constitutes payment of compensation to the employee, its tax consequence cannot be avoided by casting it in the form of a sale."

And again (Id. at 14):

> "In determining whether a particular transaction involves the payment of compensation for personal services, the decisive factor is that of intention . . . This is, of course, a question of fact."

That is precisely our contention here.

But the government apparently now contends that if there is any element of compensation—and there is, says the Commissioner—ipso facto—by virtue of the fact that the optionee is an employee—then nothing else matters. As already indicated, no court has agreed with this analysis; all the cases have examined all the facts and decided accordingly.

Before determining whether or not an option was compensatory, the courts looked to such factors as the spread between the option and market prices on the date the option was granted; whether the option was given as part of an employment contract or in lieu of salary increase; whether the employee could exercise the option only while still working for the corporation; whether the parties regarded the option as a means of enabling the optionee to acquire an interest in the corporate employer; and so on. Thus, where an employee's salary and bonus have been reasonable and adequate in the light of company policy, nature and scope of responsibility and so on, where his work continues unchanged, where

the employer decides it to be in its interest for a key employee to be given the chance to become a stockholder, where neither party is interested in or concerned about compensation, and where therefore that employee is given the option to buy stock at the same price at which that stock is being sold on the market on the day of the grant—these circumstances constitute one illustration where clearly the employee has not been given the option as compensation and therefore does not realize income when he exercises the option.

The regulations prevent such a result; they even bar the relevance of all those facts.[10]

The significant thing is that until all the facts have been examined, the correct answer cannot be determined. Since the Commissioner's regulations bar such an examination, they are invalid.

The Commissioner appears to find further support for his all-or-none position in the local law aspect of stock options. He seems to argue (brief pp. 41-43) that if the options are not granted for services, then they are without consideration and invalid to start with. Once again we urge that the Commissioner is confused.

We have here a federal tax case. We are not confronted with the question of whether a particular state

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[10] Interestingly enough even the Commissioner discusses the facts here. His brief analyzes them (pp. 30-33) for the purpose of showing that they indicate that the option was compensatory. But what difference do any of the facts make under the regulations? As a matter of fact, despite his apparently unequivocal position, in the Court of Appeals, the Commissioner nonetheless limited his argument for the validity of the regulations as they are "applied to the facts of the instant case" (brief, pp. 16, 32). If the Commissioner is right in principle there should be no exceptions. It is our contention that he is wrong in principle, that there are many exceptions, that it requires an analysis of the facts in each case to determine the correct result.

law or rule might invalidate the option. The question of consideration varies at least in degree from state to state. There is in addition no scientific standard for determining the value of the consideration running to the corporation even if it does consist, even in part, of services. Those problems are not applicable. If they were, the stock option area would be one of confusion with different results depending on the particular state law involved. As all the other cases have done, for purposes of the federal tax question involved, this Court is entitled to assume that the option is valid and effective.

Another difficulty with the regulations lies in its conflict with—of all things—the *Smith* case. It will be recalled that this Court said there that it might well be possible for "the option itself, rather than the proceeds of its exercise" (324 U.S. at 182) to represent the compensation.[11] But that result too is not permissible under the regulations. In one instance where the situation imagined by this Court actually materialized, the Court simply ignored the regulations. Without even referring to them, the Court agreed with the Tax Court that the option was, under all the facts, compensatory, but found that the option itself was the intended compensation. *McNamara* v. *Commissioner*, 210 F.2d 505 (7th Cir. 1954). See also *Commissioner* v. *Stone's Estate*, 210 F.2d 33 (3d Cir. 1954).

Once again the significant factor is that the decision was based on the Court's own evaluation of the relevant

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[11] It is of obvious importance to note that this point was specifically urged by the Commissioner in his brief in *Smith*. Thus (p. 24): "This is not to say that compensation can never be received in the form of an option to buy property from the employer, as where the employee is given a valuable option which is intended to constitute in itself the compensation." And again (p. 25): ". . . we do not contend for . . . an inflexible rule that taxable compensation cannot possibly be given in the form of an option . . .".

facts. The decisions avoided the regulations which were both applicable and mandatory in their operation. Clearly, by implication at least, the courts were saying that the regulations were invalid. The Tax Court has "said" the same thing in two cases it has heard since its decision in the instant case. *Bowen*, 13 TCM 668 (1954); *MacDonald*, 23 TC 227 (1954).

Every Economic Benefit Is Not Compensatory

But the Commissioner argues: as long as there is an economic benefit, there is an immediate tax impact, and in view of the employer-employee relationship, that impact takes the form of additional compensation—and therefore ordinary income—to the extent of the spread between option and market prices at the time of exercise; nothing else matters. We contend that this argument proves too much. There are many instances of immediate economic benefit which do not constitute taxable income. There is for one example no immediate tax on the receipt of an economic benefit in the form of a bargain purchase in the absence of the employer-employee relationship. *Palmer* v. *Commissioner*, 302 U. S. 63 (1937). Is the presence of that relationship sufficient, all by itself; and in complete disregard of everything else, to produce the opposite tax result? We urge that it is not; that the tax nature of a transaction can be properly determined only on the basis of an examination of all the relevant facts; that conclusive presumptions in factual matters are dangerous administrative expediencies—perhaps prompted, but not justified, by problems of administration—frequently rejected by the courts. *Heiner* v. *Donnan*, 285 U. S. 312 (1932); *Hoeper* v. *Tax Commission*, 284 U. S. 206 (1931); *Schlesinger* v. *Wisconsin*, 270 U. S. 230 (1926); *Commissioner* v. *Clark*, 202 F.2d 94 (7th Cir. 1953).

Interestingly enough, in a closely analogous situation even the Commissioner has refrained from conclusive presumptions. This relates to bargain purchases by stockholders. The original 1923 version of the regulations bunched into one paragraph the Commissioner's rule for finding ordinary income in the case of every bargain purchase by stockholders and employees—dividend for the former, compensation for the latter. The 1939 change eliminating the conclusive presumption continued the bunching of the two groups. One paragraph provided ordinary income treatment for both depending upon all the facts surrounding the bargain purchase; the spread between purchase price and fair market value was a dividend to the stockholder "to the extent that such difference is in the nature of . . . a distribution of earnings or profits taxable as a dividend"; it was additional compensation to the employee to the extent that it represented compensation. But when the present regulations were adopted in 1945, only the employee rule was changed. Bargain purchases by stockholders continued to be governed by all relevant facts; but similar acquisitions by employees were subjected to the same conclusive presumption which the courts had consistently rejected for 22 years.

Obviously the regulations on bargain purchases by stockholders were controlled by this Court's decision in *Palmer* v. *Commissioner, supra,* that whether a dividend is involved is a question of fact. But why should the rule be any different where the corporation-stockholder relationship is replaced by the employer-employee relationship? If employers "just don't" give options to employees except by way of compensation, corporations "just don't" give stockholders as a class the privilege of a bargain purchase except by way of dividends. The answer in each case is a matter of intention as reflected by all the facts. This Court so held in the *Palmer* case,

again in response to the Commissioner's argument. The same result should apply here.

There is still another approach which demonstrates that the government's argument proves too much. If the receipt by an employee of every economic benefit from his employer represents additional compensation, why are not employees taxable on all such receipts? Why for example is the taxability of the rental value of living quarters occupied by the employee dependent upon all the facts, including the convenience of the employer?[12] Why is that latter factor of any more significance in that connection than in connection with a bargain stock purchase? In the former connection, it is considered relevant because it involves a determination by the employer that the employee cannot do his job or cannot do it well, unless he occupies quarters provided by the employer. To take an extreme case to highlight the analogy, why is the employer's convenience any the less relevant in a situation where company policy requires that all employees at a certain level of responsibility must own a prescribed number of shares of stock in the company and where an employee eligible for promotion to that level is given say six months within which to make his bargain purchase at the fair market value on the date of promotion? Yet the Commissioner's regulation renders all of these matters irrelevant and beyond the scope of the courts' power to inquire.

Why also are employees not taxable on such things as free medical care; free recreational services, such as con-

[12] Section 29.22(a)(3) of Treasury Regulations 111. The Commissioner's effort to minimize the significance of the employer's convenience test has met with the same resistance which the various courts have shown in the stock option area. See for example *Diamond* v. *Sturr*, 221 F.2d 264 (2d Cir. 1955) which contains an interesting discussion of the history of the Commissioner's vacillation on the living quarters question.

certs, movies and athletic programs; discount purchases of the corporation's product on sale to the general public? In every instance, each of the government's tests is satisfied: an economic benefit passing from employer to employee for less than fair market value. Yet no tax is imposed. And for good reason. None of those things is intended as compensation; they are conferred instead as a means of making the employer's place of business a nicer place to work; to build up employee morale and spirit; to create a feeling of friendship between employer and employee, a feeling on the latter's part that his was more than just a job—all designed to inure to the corporation's benefit in the form of better service, more loyal service, less absenteeism, and the like—no different in principle from the corporation's expected benefit from giving a stock option to certain employees.[13]

None of these fringe benefits is taxed as income to the employees receiving the immediate economic benefit from their employers—for the reasons indicated. There is no special reason applicable to just one of those fringe benefits—stock options—which permits, let alone requires, totally different tax treatment. In fact what differences may exist illustrate that the economic gain is more direct, more concrete and less fortuitous in the case of all the fringe benefits listed above other than the stock option. In the latter case, the amount of economic benefit is determined solely by the employee by his decision whether and when to exercise his option; even then he has done no more than make a bargain purchase. In the case of

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[13] See *Peters* v. *Smith*, 221 F.2d 721 (3d Cir. 1955) for a recent example of a "fringe benefit" not taxable as compensation.

An interesting analogy in this connection concerns the unquestioned deductibility of business gifts as ordinary and necessary business expenses on the theory that the donees' good will is important to the corporation's welfare. Such business gifts are not taxed as income to the donees.

the other fringe benefits, the economic benefit is not subject to the employee's control; as just stated, it is direct, concrete and immediate.

If then the existence of the employer-employee relationship does not mean that every economic benefit conferred on the employee is automatically taxable as additional compensation, there is such a thing as a non-compensatory stock option similar to a bargain purchase and therefore without tax incident at the time of receipt or exercise of the option.

As the court below said (223 F.2d at 368):

> "A virtually unbroken line of cases supports the Tax Court in holding that if the grant of a stock option by a corporation to its employee is intended as additional compensation to him the excess of the fair market value over the option price is income taxable to him when the option is exercised, but on the other hand if the grant of the option is intended to provide him with a proprietary interest in the business no taxable gain is recognized when the option is exercised, whether the grant of the option is the one or the other being in every case a question of fact."

Legislative History

We have attempted to show that both as a matter of extensive and consistent judicial precedent and on the merits as a matter of first impression, the Commissioner's regulations go far beyond their permissible scope and are therefore invalid. Since we are talking about the meaning of an underlying statute, it is of obvious significance to attempt to determine Congress' feeling in the matter. Congress has made it very clear that it agrees with our analysis on two of the occasions that it has considered the matter.[14] The first was the abortive

[14] For similar expressions of Congressional opinion see 93 Congressional Record A4320, A4322.

effort in 1948 to enact the first specific provision dealing with stock options. The second was the actual adoption two years later of the new concept of "restricted stock options". It was because Congress thought that the regulations were invalid, that at least as to the future, corrective legislation was necessary in a prescribed area.

In 1948, Section 137 of HR 6712, known as the General Revenue Revision Bill of 1948, proposed to adopt rules covering all options (a result which the Commissioner attempts to achieve through the regulations). HR 6712 not only proposed to deal with restricted stock options, it provided also a "General Rule" as to all other options. That general rule would in effect have adopted the Commissioner's entire position but only with respect to options granted after the date of enactment. Section 137 (f)(1). In other words, the bill (which never became law) purported to cover the entire field of stock options but only as respects those options not then in existence. Presumably, the then existing law would govern all other options, including those exercised after the date of the proposed change.

In proposing Section 137, the House Ways and Means Committee had this to say as to the regulations (Report No. 2087, 80th Cong. 2d Sess., p. 4):

> "At the present time the taxation of these options is governed by regulations which are so severe that in effect they prevent the use of the employee stock option for incentive purposes. Moreover, these regulations constitute an extension of the Supreme Court decision upon which they are based (*Commissioner* v. *Smith* . . .) The resulting uncertainty is an additional reason for congressional action at the present time."

It was with this history in mind that Congress passed the Revenue Act of 1950 adding what is now Section 421 to the Code. But the new section deals only with restricted stock options; it does not include any provisions purporting to establish a general rule.

In these circumstances this question is presented: what is the tax status of employees' stock options granted and exercised at times which satisfy the time requirements of Section 421, but which do not in the first instance qualify as restricted stock options within the statutory definition of that term? Put another way, does Section 421 provide an exclusive rule whereby stock options can avoid ordinary income treatment? Are all other employee stock options automatically, upon their exercise, compensation in the hands of the optionee? If the answer to that question is in the negative, then *a fortiori* there can be no conceivable argument that the spirit or purpose of Section 421 in any way supports the regulations.

That the answer is unequivocally in the negative is clearly indicated both in the background recited above and in the legislative history of Section 421 itself.

As to the latter, the Senate Finance Committee, which first inserted the stock option provisions in the bill (HR 8920) which had already passed the House, stated that the changes were designed to establish "a *new* set of rules for the tax treatment of *certain* employee stock options" (italics added) (1950-2 Int. Rev. Cum. Bull. at 526), and (Ibid.):

> "Moreover, your committee believes these regulations go beyond the decision of the Supreme Court in *Commissioner* v. *Smith.*"

The report states also that "options which do not qualify as 'restricted stock options' will continue to be taxed *as under existing law*" (italics added) (Ibid.); this same point is made elsewhere in the report (Id. at 552). Obviously, the words "existing law" must have meant Section 22(a) as interpreted and applied by the various courts. That means that options which do not qualify as restricted stock options are to be analyzed—on their facts—to determine whether they are proprietary or com-

pensatory—in precisely the same way as before the statute was changed.

As a matter of fact the Committee Report specifically recognizes the distinction between proprietary and compensatory options (Id. at 526):

> "Your committee's bill (section 220) establishes a new set of rules for the tax treatment of certain employee stock options. Such options are frequently used as incentive devices by corporations who wish to attract new management, to convert their officers into 'partners' by giving them a stake in the business, to retain the services of executives who might otherwise leave, or to give their employees generally a more direct interest in the success of the corporation."

That this distinction still exists must follow unless the words "existing law" are read to mean "existing Commissioner's regulations". But such a tortured reading flies squarely in the face of the Committee's own explicit denunciation of the validity of those regulations. Congress could hardly have intended to characterize as existing law the very rule which it said was wrong and which prompted the legislation in the first instance. Furthermore, in the very same paragraph where it used the phrase "existing law", the Committee used the phrase "existing regulations" where it was clear that the reference was to the regulations. This conclusion is further fortified by realization of the fact that, as described above, between the years 1923 and 1939, when the regulations contained in effect the same conclusive presumption of compensation as appears in the current regulations, the "law" was as the various courts determined—not what the regulations said. Under the "law", the courts have the exclusive right to determine whether the option in each particular case was in the nature of compensation—*regardless of what the regulations said.* The

"law" since the *Smith* case is the same.[15]

Certainly this discussion makes it entirely clear that the restricted stock option section did not establish an exclusive rule for the treatment of all employee stock options. If that had been the congressional purpose, it would have been an exceedingly simple thing to do—in exactly the manner proposed in 1948 in HR 6712. There the House stated the general rule to the effect that unless the option was a restricted stock option, it would involve compensation to the extent of the spread in the year of exercise. If HR 6712 had become law, the question might have been foreclosed; the tax status of employee stock options might have been fully determined[16] (except possibly for some constitutional question). But that is not what was said in the Revenue Act of 1950. The act itself provides rules *only* with regard to restricted stock options, and the committee which drafted the provisions stated that all other options are to be determined by "existing law". The committee stated also that "the section contains no rules applicable to transactions respecting stock options which are not 'restricted stock options' as defined in the section" (1950-2 Cum. Bull. at p. 552). Since Congress was once on the verge of laying down an all inclusive rule and did not do so, when it thereafter did enact some provisions which by their terms deal only with certain phases of stock options, the conclusion is inevitable that these provisions have no effect on all

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[15] In addition to the cases already cited, see for example *Babbitt*, 23 TC 850 (1955); *Sorenson*, 22 TC 321 (1954); *Rosenberg*, 20 TC 5 (1953); *Clark*, 9 TCM 719 (1950); *Nicolson*, 13 TC 690 (1949); *Lamond* 5 TCM 51 (1946).

[16] The regulations proceed on the theory that the statute so provided back in 1945. If that is what the statute had said or could reasonably have been interpreted to mean, there was hardly any need for the proposed statutory change in 1948.

other phases of the question. They continue to be governed by existing law as developed by the courts.

The question in each case of non-restricted stock options continues to be whether or not the particular option involves compensation. In other words, the tax status of non-restricted stock options would be exactly the same as it was prior to the passage of the Revenue Act of 1950.

The Commissioner argues that if this is so, then the holder of a restricted stock option fares no better than taxpayers in the position of the respondent here. Once again the Commissioner is confused: Section 421 starts out with the assumption that the options within its scope run the serious risk of being treated as compensatory. It then goes on to provide that if certain potentially compensatory options satisfy certain specifications, then the normal likely result of compensation does not follow. In the absence of Section 421, the options to which it applies would have had to run the gauntlet of the proprietary v. compensatory test and would perhaps have been treated as compensatory; that risk is eliminated.

There is no inconsistency. The Commissioner is wrong in his argument that congressional purpose is being stultified.[17]

Summarizing, by the adoption of section 130A in 1950 Congress in effect said:

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[17] He contends further (brief p. 39) that the Congressional purpose is further thwarted by the loss of revenue arising out of the applicability of capital gains tax to the gain and the complete elimination of any ordinary income. The Commissioner overlooks the fact that if ordinary income is involved for the optionee, the corporation gets a corresponding off-setting deduction from ordinary income. There is no corporate deduction where only capital gains apply.

1. The law has been consistent and clear for a long time, that there is a distinction between compensatory and proprietary stock options, and that the real nature of a particular option depends upon the relevant facts.

2. *Commissioner v. Smith* did not change the law.

3. Existing regulations are therefore invalid and have created needless uncertainty and litigation.

4. Since the regulations apply only to options granted after the date of the *Smith* decision (February 26, 1945), we are concerned only with such options. Even as to them, if they were exercised after 1949, we do not establish any all-inclusive rule. Instead we do just two things.

5. First, we adopt the concept of the "restricted stock option" with specified tax results, in order to avoid the question of fact (proprietary v. compensatory) in a prescribed area.[13]

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[13] Cf. *Helvering* v. *Clifford*, 309 US 331 (1940) where taxpayer had argued that Sections 166 and 167 (dealing with the taxability of income of certain short term trusts to their grantors) constituted the exclusive method of producing that result, so that the income of trusts outside of those two sections could not by any other means be taxed to their grantors. But this Court rejected that argument and said (at 337-338):

> "In view of the broad and sweeping language of § 22(a), a specific provision covering short term trusts might well do no more than to carve out of § 22(a) a defined group of cases to which a rule of thumb would be applied. The failure of Congress to adopt any such rule of thumb for that type of trust must be taken to do no more than to leave to the triers of fact the initial determination of whether or not on the facts of each case the grantor remains the owner for purposes of § 22(a)."

So here: the adoption of Section 130A has the effect only of carving out of Section 22(a) a defined group of employee stock option cases to which specified tax results would be applied. But all other employee stock option cases were not carved out; they remained subject to analysis for the purpose of determining whether or

6. Second, as to all other options, they are to be tested by the standards announced by the various court decisions. This includes options issued prior to the effective date of the 1950 change, regardless of what they say, as well as options issued after that date if they do not qualify as restricted stock options. *As to all those other options*, it continues to be a question of fact in each case.

We cannot see how this congressional action—reviewed against the background of what Congress failed to do two years earlier—provides the slightest support for the regulations or for any conclusive presumption of the fact of compensation in every case. To the contrary, this congressional action requires precisely the opposite result.

In view of the Commissioner's own vacillation on the point, the Court's disregard and rejection of the conclusive presumption in the original regulations, and Congress' own clear expression of opinion that the current conclusive presumption is unwarranted, it is little short of amazing for the Commissioner to argue—even in only a footnote (note 20, p. 45)—that the regulations are entitled to substantial weight. The argument becomes even more amazing when viewed in light of the Commissioner's somewhat different contention before this Court in his brief (p. 22) in the *Smith* case where he was talking about the earlier version of the regulations which handled each case on its own facts.

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not they are compensatory. Just as the enactment of Sections 166 and 167 did not affect the taxability under Section 22(a) of trusts which did not qualify under the amendments, so the passage of Section 130A is not in any way determinative of the tax status of stock options which are beyond the scope of that section. In other words, as the Senate Finance Committee report said, such options are to be treated under existing law without regard to 130A.

"The governing Treasury Regulations providing that where property is transferred by an employer to an employee for an amount substantially less than its fair market value, the employee shall include the difference in his gross income *to the extent that it is in the nature of compensation* for services, expresses well settled principles, is of long standing, and must be deemed to have Congressional approval" (italics added).

CONCLUSION

The conclusion is inevitable that the regulations represent the Commissioner's attempt to reverse the whole host of cases which determine the tax nature of employee stock options on the basis of the particular facts in each case. The conclusion is inescapable that, without the benefit of any statutory or judicial change, the Commissioner has, by administrative fiat, attempted to legislate out of existence the distinction between proprietary and compensatory stock options which the courts consistently developed over the years and which in fact started at a time when the original version of the regulations said that there was no such distinction. The Commissioner has by administrative fiat attempted to create income where in fact there is none. Congress has never said that every stock option involved compensation taxable as such. Legislative history clearly requires the conclusion that congressional opinion is precisely to the contrary.

We respectfully urge this Court to affirm the decisions below that Section 39.22(a)-1(c) of Treasury Regulations 118 is invalid and that the tax nature of employee

stock options is to be determined by the facts in each case.

Respectfully submitted,

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